Market Commentary
Fourth Quarter, 2017

2017 was a near perfect year for equity investors, with steady global growth, low inflation and very low interest rates. Job growth was strong, with 2.06 million new jobs created. The unemployment rate declined to 4.1%, the lowest since 2000, and wage growth increased by 2.5%. Core CPI was up 1.7%, below the Federal Reserve Open Market Committee's (FOMC) 2% target.

So how strong was the domestic stock market last year? Including dividends, the S&P 500 return was 21.8%. Eight of the eleven primary sectors had double-digit positive returns, led by technology, up 39%. The two lagging sectors were energy and telecom, declining by a mere 1%. The S&P 500 Index had positive returns every month, made 62 all-time highs and did not have an intra-year decline greater than 3%. For context, the average intra-year decline since 1980 is 14%, and in the prior five years it was 11%, 12%, 7%, 6%, and 10%. It was a very good year.

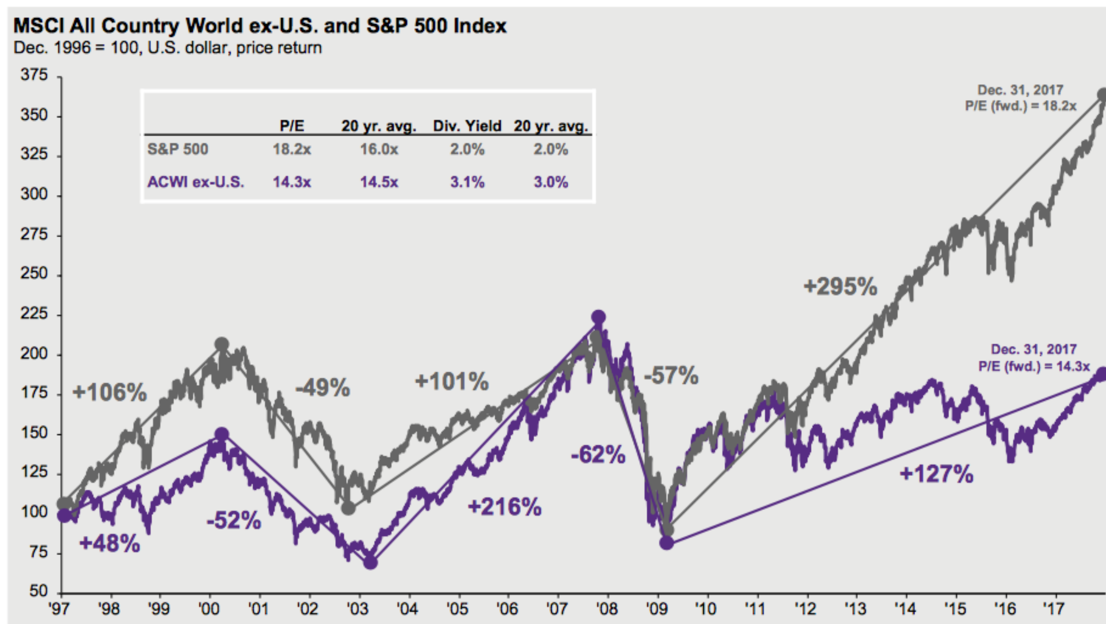
Foreign equity market returns were even better than domestic, with the All Country World Index ex-U.S. (ACWI) returning 27.8% in U.S. dollar terms. ACWI includes both developed and emerging markets. Viewed separately, the developed international and emerging markets returns were 25% and 37%, respectively. These returns were aided by a weaker dollar relative to other currencies. Dollar weakening helps international returns and dollar strengthening hurts international returns. We expect additional dollar weakness in 2018.

Long term bond yields were relatively unchanged, with the 10 year treasury bond yield declining from 2.45% at the beginning of the year to 2.41% at the end of the year. Short term interest rates rose, with the 2 year treasury bond yield increasing from 1.20% at the beginning of the year to 1.89% at the end of the year. Fixed income returns were in the low to middle single digits, depending on the duration of the fixed income securities.

The FOMC recently announced it expects to increase short term interest rates three times in 2018, bringing its target range to between 2% and 2.25%. In addition, if the economy is stronger than expected, fueled by tax cuts, infrastructure stimulus or other factors, long term rates will probably rise in 2018. However, with inflation subdued, short term rates may increase more than long term rates again in 2018, causing additional flattening of the yield curve. If so, reinvestment yields from maturing bonds will be compressed regardless of maturity, and the additional yield from extending bond maturity duration will decline.

We expect a modest favorable impact on economic growth from the tax cuts in 2018. However, we do not believe a surge in capital expenditures, higher consumer spending and repatriation of overseas cash will be enough to sustain higher domestic economic growth longer term. There are too many offsetting factors: shortage of workers, an aging population, unfunded medical and retirement benefits and increasing deficits and debt, all which will constrain growth. Our expectation for modest long term domestic growth remains unchanged.

The graph below compares the S&P 500 and the All Country World Index (ACWI) ex-U.S. for the last twenty years. The most dramatic visuals are the 295% increase in the S&P 500 since the March 2009 low compared to the 127% increase in ACWI for the same period, and the rapid and steep peak to trough decline in 2008-2009 for all equities. Less obvious and just as important are the current valuations. The forward price to earnings multiple (PE) of the S&P 500 and ACWI are 18.2x and 14.3x, respectively, compared to their 20 year averages of 16.0x and 14.5x. Based on the historical PE's, ACWI is much cheaper than the S&P 500.



Source: MSCI, Standard & Poor's, FactSet, J.P. Morgan Asset Management.
Forward price to earnings ratio is a bottom-up calculation based on the most recent index price, divided by consensus estimates for earnings in the next twelve months (NTM), and is provided by FactSet Market Aggregates. Returns are cumulative and based on price movement only, and do not include the reinvestment of dividends. Dividend yield is calculated as consensus estimates of dividends for the next twelve months, divided by most recent price, as provided by FactSet Market Aggregates. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – U.S. Data are as of December 31, 2017.

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Asset Management

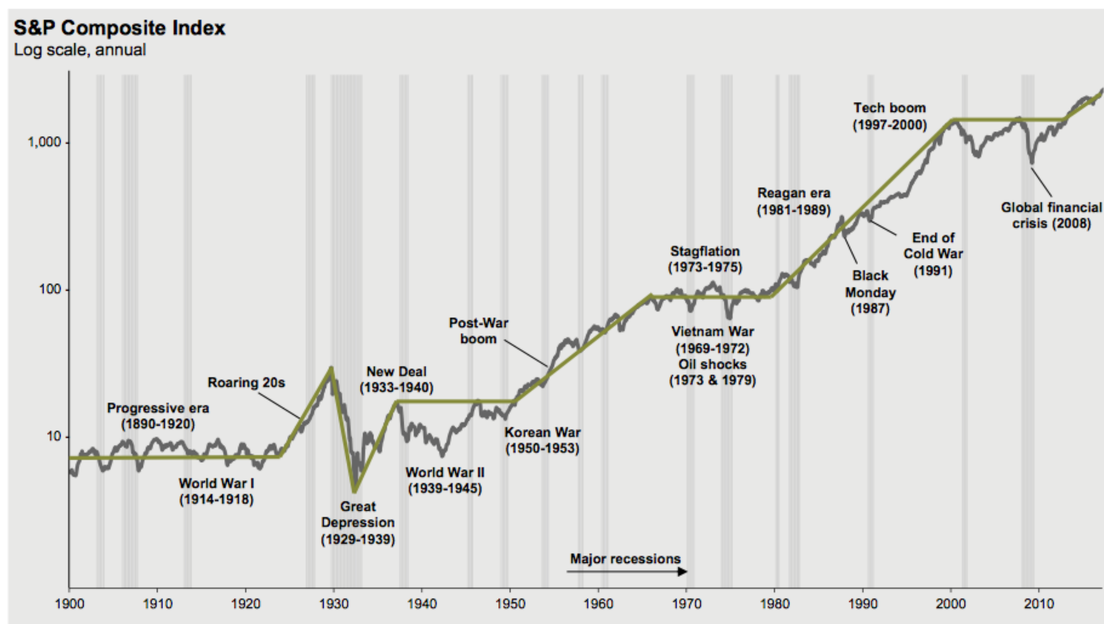
Valuations are a poor indicator for asset allocation timing decisions. Short term results are determined more by investor sentiment and the flow of funds momentum in to or out of different asset categories than current valuations. Momentum and investor enthusiasm can cause

expensive markets to go much higher than you think, just as momentum and investor pessimism can cause markets to go much lower. For example, consider the valuation gap between the S&P 500 and ACWI in 2014. Had we sold domestic equities based strictly on valuation without consideration of other factors, we would have missed out on the returns in the subsequent years.

On the other hand, valuations are powerful predictors of future ***long term*** returns, and the longer the time period the higher the correlation. Based on relative valuation, we expect better future returns from ACWI than the S&P 500. Although the S&P 500 valuation is higher than ACWI, absent a recession, which we do not expect in 2018, the domestic equity market may continue grinding higher longer than many expect, but long term returns will likely be much lower than recent years.

We believe strongly in the merits of a diversified investment portfolio and tilting asset allocation to over-weight asset categories with lower valuations and under-weight asset categories with higher valuations, consistent with the investment objectives and risk tolerance of each client. During the last year, we gradually increased the allocations to both developed international and emerging markets equity asset categories.

Although the recent rise in domestic equities seems extreme, a longer term chart provides important perspective. The shaded columns below indicate recessions.



Source: FactSet, NBER, Robert Shiller, J.P. Morgan Asset Management.
Data shown in log scale to best illustrate long-term index patterns.
Past performance is not indicative of future returns. Chart is for illustrative purposes only.
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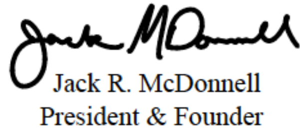
There are a few key take aways from this chart: 1.) markets can go up or sideways for extended periods of time; 2.) markets are resilient; and 3.) historical returns long term have been very good in spite of market declines during the Great Depression, multiple wars, stagflation, the tech boom/bust and global financial crisis. Although current valuations may imply lower expected returns in the near term, we remain optimistic about the US economy long term. Capitalism and the free market system have handsomely rewarded steadfast and patient investors for the last century. We are optimistic that it will continue to do so for the century to come.

Thanks again for your trust and confidence. Best wishes for a healthy, happy and prosperous 2018.

Respectfully,



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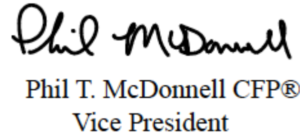

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